REFORM

WORKING PAPER

COMPANIES ACT

Québec

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Finances Québec

Reform of the Companies Act
Working Paper

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A word from the Minister

The Québec Companies Act is considerably behind other Canadian and international company legislation as far as competitiveness is concerned. In fact, the last major updating of this Act was done in 1981.

It is now high time to amend the *Companies Act* to modernize its structure. The reform must allow an examination to be conducted of the basic provisions governing the incorporation of a company, as well as the rights and responsibilities of shareholders and directors. This reform must also incorporate critical provisions for the protection of the interests of shareholders, creditors, employees and other stakeholders. Accordingly, the Companies Act could become a modern tool of economic development likely to maintain existing companies within Québec's jurisdiction and also attract companies seeking a welcoming legislative structure.

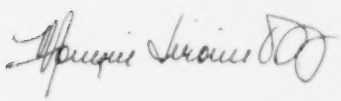
The working paper deals with problems in connection with the main elements of the Act. Solutions are suggested to solicit comment. Members of the general public as well as experts are invited to suggest their own amendments or to invoke other stakes if they wish to do so.

This is the beginning of a first analysis of the real needs mentioned up to now by the interested parties. The object of this reform is to strike a proper balance between modernism, streamlining corporate law, competitiveness and protection of the various actors subject to this Act.

The reform of the Act is a broad endeavour which is of substantial complexity. This is why I am convinced that this consultation will be most useful to ensure this reform progresses rapidly.

Within the scope of this consultation, interested parties may call on their knowhow or simply give their opinions, whether favourable or not, concerning the ideas discussed. I personally thank all participants for the comments, suggestions and recommendations they will make and which will be a beacon for this reform.

Minister of Finance,
Minister of Government Services,
Minister Responsible for Government Administration and
President of the Treasury Board



Monique Jérôme-Forget

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Introduction

Shortcomings have been noted in the Companies Act (hereafter the "Act") for several years now. For example, the Act is not adapted to the new widely applied rules of governance. Concretely, the Québec Act is somewhat behind the times when compared with similar legislation in other jurisdictions in which more severe rules of disclosure have been adopted. What type of amendments are to be made to our Act? This reform is a chance to answer this question.

Other stakes must be analyzed during this reform. A study of these stakes will allow gleaning new ideas about company law so as to make the Act into a tool worthy of the beginning of the 21st century and better adapted to the various needs of its current and future clientele.

Presently, the main clientele of the Act is made up of small and medium enterprises (SME). In fact, companies having less than 100 employees – the maximum limit most often used to define an SME[1] – represent more than 90% of all companies incorporated under the Act (under Parts I and IA)[2].

In 2005, SMEs supplied 54.3% of total employment in Québec. From 2000 to 2005 they created 48% of all jobs[3]. Therefore, there is no denying the importance of SMEs in the economy of Québec. This is why the government intends to use this reform to analyze the effect the Act may have on the incorporation and operation of SMEs and to assess the possibility of better adapting the Act to this clientele.

In fact, this reform will be a chance for all interested parties to study among other things the possibility of having the provisions of the Act adapted or not, to the size of a company.

Considering the stakes in connection with company law, this paper outlines governing principles which may guide the reform process. Accordingly, an amended Act should among other things:

- Improve the decision-making process so that the company will be able to react more efficiently in a context of competitiveness;
- Facilitate access to capital using more efficient means while protecting the main actors involved;
- Allow companies to go through all the stages in their growth more easily.

(1) STATISTICS CANADA, *Labour Force Survey*, 2006.

(2) COMPUTER CENTRE OF THE QUÉBEC REGISTER OF ENTERPRISES, *Enterprise Registrar*, 2006.

(3) SCOTIA BANK, *Small Businesses and Jobs*, 2005.

1. PRESENT SITUATION

1.1 Current structure of the *Companies Act*

In addition to specifying the rules of incorporation, a companies act defines and regulates a whole series of relationships among a variety of actors. Such an act is vital, not only as far as companies are concerned, but also for the economy.

In Québec, the *Companies Act* governs incorporation, the existence and the end of an enterprise which is a moral person, that is to say, having a legal existence distinct from that of its founders. This moral person is either a profit or not for profit organization.

To accomplish its objectives, the Act is divided into four parts.

Under Part I it is possible to incorporate a company by filing letters patent with the Enterprise.Registrar Part I also has basic provisions which apply to legal persons incorporated under another part of the Act, such as Part IA by making the "necessary modifications."

Part IA as we know it was added in 1981. It provides for the incorporation of a company by the simple filing of articles with the Enterprise Registrar. It also provides for the incorporation of a company founded and managed by one person, that is to say, a one-person company. It is useful to underline the fact that since 1981, it is no longer possible to incorporate a company under Part I. However, there are still more than 5000 companies in Québec which are incorporated under that Part. On the other hand, some provisions of Part I apply to companies incorporated under Part IA. These are two factors which complicate an understanding of the Act.

Part II concerns joint stock companies, that is to say, government organizations or any other legal person incorporated under special legislation for any purpose other than the building and working of railways or for any other purpose for which other special provisions of law exist, including insurance companies, as a complementary adjunct to its incorporating legislation. Accordingly, Hydro-Québec and the Société des alcools du Québec, two state corporations which pay dividends to the government, their sole shareholder, are governed in addition to the provisions of their incorporating legislation, by the provisions of Part II. This Part essentially reproduces the provisions of Part I.

Part III concerns the incorporation of personalized associations, that is to say, not for profit organizations which seek to have a legal personality distinct from that of their members.

Reform of the law concerning personalized associations

In 2008, the Department of Finance will undertake similar steps to reform Part III of the Act concerning personalized associations. A working paper will also be available shortly.

The provisions of the Act sometimes apply in the absence of any agreement between the parties (which is the case of most of the rules governing the existence of a legal person) and are sometimes of public policy, that is to say that it is impossible to derogate from them even if the parties agree to do so (this is the case with the rules governing the incorporation of legal persons).

The provisions of the Civil Code of Québec are supplementary law when it is necessary to complete the provisions of the legislation applicable to legal persons, in this case the Act and other legislation applicable to legal persons (for example: the *Act respecting the legal publicity of sole proprietorships, partnerships and legal persons*).

1.2 Main stakes in the reform of the *Companies Act*

When compared with company law in other jurisdictions in Canada, Québec law governing legal persons currently has few legal recourses specifically adapted to investors. Although some recourses are provided under the Civil Code of Québec, Québec investors have less legal protection in comparison for example with the federal regime which provides preventive rights and curative recourses for shareholders (shareholders' proposals, voting by class, right of dissent, oppression remedy, etc.).

On the other hand, most Canadian provinces have revised the rules in their company legislation governing the operation of legal persons. On this point the provisions of the Act are complex so that the persons involved have difficulty among other things in respecting the rules concerning notices of convocation or the holding of annual meetings. The examination of these pivotal provisions is one of the numerous stakes in the proposed reform.

As far as the stakes specific to public companies are concerned, the fact must be underlined that the Act has not evolved at the same pace as current financial practices, for example the practice concerning the dematerialization of company securities(1). The Act still provides that a shareholder has the right to receive a paper share certificate from the company, although in practice thanks to centralized registers created for the benefit of companies, most shareholders have a statement of the registration of the securities they own.

(1) The Canadian Capital Markets Association has been requesting for years now to have securities dematerialized, that is to say to not to fill out paper share certificates for securities issued by companies so as to complete a settlement for financial transactions in T+1 (real time plus one day) rather than T+3 which is currently required.

The legal protection given to investors under the Québec regime could also be improved in connection with the indirect detention of securities (broker or clearing house). There is a legal ambiguity concerning property rights of company securities in transactions in which securities are held indirectly (sale, surety . . .).

The Act may also have to be amended if bearer shares were no longer to be permitted, as has been requested by some actors for purposes of efficiency is settling transactions or in the fight against money laundering.

On the other hand, the provisions of the Act have not been adapted to new information technologies. In fact, the Act does not take into consideration changes in business practices although some of these realities are now included in the *Act to establish a legal framework for information technology*.

In addition the Act does not have any special provisions concerning shares with multiple voting rights. Accordingly, the possibility of legislating in this field could be subject to analysis.

As far as provisions concerning good governance are concerned, the Act currently has only a few partial ones concerning audits. Therefore, it is appropriate to question the relevancy of adding any others.

Such rules may be far-reaching because in some other jurisdictions they may include provisions about the functioning of boards of directors or tasks in connection with audits and shareholders' information rights. Some states, such as the United Kingdom, have included in their company acts provisions concerning good governance, among others, the obligation for company directors to *immediately* disclose following an important announcement, all details on the company's Website with a notice to the shareholders requesting it. This requirement is designed to allow shareholders to answer or to exercise their rights with full knowledge in more appropriate timelines and to encourage equal access to information between shareholders and markets.

Finally, the lack of a periodic review of the Act appears to be a shortcoming for which the government could consider proposals.

Without being exhaustive, this enumeration of the stakes involved shows a real need for a reform.

1.3 Critical modernization

Jurisdiction "shopping" is ever more prevalent in Canada and on an international scale. In fact, directors of enterprises have access to company legislation which is increasingly competitive.

Jurisdiction "shopping"

In company law, jurisdiction "shopping" is the attempt to seek legislation (and the administration of such legislation) likely to reduce the cost of basic and accessory transactions for majority shareholders, officers and company directors. (2).

On the other hand, over the last few years, more than one-third of all companies incorporated annually under federal legislation are from Québec(3). Provincial corporate law should be more welcoming to Québec businesses.

Considering all the reforms applied or presently being applied elsewhere, Québec company law, which was already not up to date for years, has now become completely obsolete.

It is therefore easy to understand that foreign enterprises doing business in Québec or those coming from Québec are tempted to incorporate under legislation in another jurisdiction which is more adapted to their legal needs, whether on a functional or operational basis.

Considering that the Act is a lever for a competitive economic environment by attracting investments and in doing so it contributes to economic development, the reform work for this Act becomes indispensable.

(2) MARIE-ANDRÉE LATREILLE, « *Le phénomène du « shopping » de juridictions pour personnes morales : c'est sérieux !* »,[Jurisdiction Shopping for Legal Persons : Something Serious!] Annual congress of the Bar of Québec, Montréal, 1998.

(3) Out of the 21,053 companies incorporated under federal jurisdiction in 2006, 7,617 were from Québec. In 2005 and 2004, out of respectively 20,257 and 19,066 companies incorporated under federal jurisdiction, 7,889 and 7,437 were from Québec. SOURCE: Corporations Canada, May 2007.

2. REFORMS UNDERTAKEN ELSEWHERE IN CANADA

2.1 Canada

Industry Canada, the federal department in charge of the application of the *Canada Business Corporations Act* (CBCA) has announced consultations for the five year review provided in this act since the wide sweeping reform in 2001

The working paper entitled *Towards an Improved Standard of Corporate Governance for Federally Incorporated Companies: Proposals for Amendments to the Canada Business Corporations Act*, was distributed on a national level in May 2004. The federal government made the commitment to enact legislative reform to ensure that the standards of governance of federal corporations remain of the most stringent nature.

The proposals for reform of the CBCA made during the consultation were designed to increase transparency and accountability of corporations to investors and shareholders. These proposals concern the role and composition of boards of directors, the independency and supervision of auditors, financial statements and application of the act.

2.2 Ontario

On May 11, 2005, during the Budget Speech, Mr. Greg Sobora, the Minister of Finance of Ontario, announced his intention to conduct a broad reform of corporate and commercial legislation. The government specifically acknowledged that such a reform was necessary for Ontario to remain competitive in comparison with standards which have become international. In doing so, the government of Ontario has acknowledged that the legislative environment is an important factor in the overall investment decision-making process.

Ontario established a three-step plan. The first step involved the adoption of the *Securities Transfer Act*, which came into force on January 1, 2007. The second step was to put the accent on the reform of the *Ontario Business Corporations Act*, or OBCA). On this point, Bill 152 received royal assent on December 20, 2006 and came into force on August 1, 2007. This act considerably amended the OBCA by harmonizing it among other things, with the federal act. As far as the third step is concerned, it will reduce and simplify the legislation applicable to not for profit legal persons.

Among other features, the reform of the OBCA introduced the following amendments:

— The obligation of residence which required 51% of directors of an Ontario company to reside in Canada, was reduced to 25% of the number of directors;

— The rules concerning conflict of interest between directors and the company were amended. Directors must now not only abstain from voting on the issues at the basis of the conflict of interest, but they must also leave the meeting of the board of directors for the duration of the discussion;

— The defence of due diligence for directors has been broadened.

2.3 Alberta

During the Budget Speech in March 2004, the government of Alberta announced its intention to make amendments to its company legislation. These amendments were adopted and it is now possible to incorporate an unlimited liability corporation (ULC) in Alberta. In doing so, Alberta is seeking to increase its share of the incorporation market in Canada, especially for American companies which use ULCs for tax planning purposes. Up to then, only Nova Scotia offered this possibility to American corporations, and a large number of them were quick to establish the head offices of their Canadian subsidiaries there.

In Alberta, shareholders have unlimited, joint and several liability, which may be invoked at any time by company creditors and not only when the company is being wound up as is the case of ULCs in Nova Scotia. In fact, in that province, shareholder liability is limited but residual, that is to say, it will be sought only when the corporation is wound up and if it does not have sufficient assets.

Alberta corporate legislation is in many respects more modern and flexible than Nova Scotia legislation and this favours it for jurisdiction shopping. Once amended, the Québec legislation should be a solid competitor of the Alberta legislation.

The advantage of creating this type of legal person in Québec would be to incite American shareholders (directors) to establish their Canadian subsidiaries in Québec because of the tax flexibility this would allow them to have in the United States.

2.4 British Columbia

British Columbia completed a major and significant reform of its corporate legislation. The *British Colombia Business Corporations Act* (BCBCA), which came into force on March 29, 2004 and its regulation, the *Business Corporations Regulation*, replaced several acts at the same time.

The new act is an answer to the commitment made by the government of British Columbia to ensure that it is easier, faster and more economical to do business in that province.

This act replaced corporate legislation which became outdated. It ensures greater flexibility to corporations in the fields of governance of enterprises, management and finance. It created an environment that is more open to international investment especially by repealing the conditions related to place of residence of directors and among other things it simplified the rules governing conflict of interest.

The act also acknowledges technological advances and allows corporations to file documents concerning their incorporation online by a new service called Çorporate Online.

Comparative table of some important features of corporate legislation

	Québec *Companies Act*, R.S.Q. c. C-38	**Alberta** *Business Corporations Act*, c. B-9 RSA 2000	**Ontario** *Business Corporations Act*, R.S.O. c. B.16	**Canada** *Canada Business Corporations Act* R.S.c. C-44	**Delaware** *Delaware Code Title 8 - Corporations*
Last revised	1981	2005	2007	2001	2007
Specific chapter/provisions for SMEs	No	No	No	No	Yes
Provisions favouring use of new information technologies	No	Yes	Yes	Yes	Yes
Provision broadening administrators' protection from recourses (Raincoat Provision)	No	No	No	No	Yes
Statutory remedy for oppression	No	Yes	Yes	Yes	No
Financial assistance permitted for shareholders	No	Yes	Yes	Yes	Yes, on condition
Unlimited liability corporations	No	Yes	No	No	Yes, choice to be made
Continuation possible	No	Yes	Yes	Yes	Yes

"Raincoat Provision": A clause included in a company's articles of incorporation which exonerates directors ahead of time for infringement of their duties of prudence and diligence.

Recourse for oppression: This is a recourse in equity which grants a court broadened remedial powers in case of an abuse of right or an injustice on behalf of a company or its directors and which infringes the interests of any person having sufficient interest to institute such recourse.

Financial assistance: This is an operation to give company money or assets to its shareholders. This transaction may sometimes be a loan or a surety. This transaction may sometimes be useful for the financing of a company.

Unlimited liability corporation: This is an additional type of corporation which may be incorporated and in which the liability of shareholders which is usually limited, is unlimited in case of the winding up of the company if its assets are insufficient.

Continuance: Continuance is a procedure by which a company incorporated under a specific act may continue its existence under company legislation in another jurisdiction.

3. MAIN THEMES TO BE DEALT WITH DURING THE CONSULTATION

The goal of the reform is to make the Québec Companies Act into efficient, modern and simple legislation to contribute to stimulate economic activity in Québec. The main stake involves establishing a balance between the protection of shareholders, other interested parties and the accomplishment of the financial objectives of companies.

3.1 Protection of shareholders

The Québec Act is distinguished from the CBCA and other provincial legislations by the fact that it grants shareholders fewer rights, powers and protection.

Therefore, the reform of this Act is a chance to make a choice: is it appropriate to maintain the present status of shareholders' rights, powers and protection or is it appropriate to increase them or to reduce them by increasing the protection awarded to directors?

3.1.1 Status quo

The first choice involves leaving the shareholders' rights, powers and protection "as is" or almost "as is".

It is possible that for some persons who intend on incorporating, the few rights and the slim protection of minority shareholders may be one of the major attractive features of the Act in comparison with the CBCA. These persons are mainly majority shareholders, directors and officers of companies. They want to have the least amount of obligations towards minority shareholders and thereby limit any risk of recourse on their behalf. A legal framework which grants fewer rights and recourses to minority shareholders will undoubtedly satisfy them.

❑ Advantages and inconvenience

The choice of status quo would be warranted if the intent is to have the Act stand out as far as jurisdiction shopping is concerned. The Act would continue to satisfy and attract some majority shareholders, directors and officers because it has limited provisions as far as shareholder protection is concerned.

The relevancy of such a choice may be questioned to the extent that most of the clientele of the CBCA comes from Québec and the fact that this legislation grants more shareholder protection than the Act. In addition, such a choice would be contrary to international tendencies concerning good governance, which feature an increase in the rights, powers and protection of minority shareholders.

As far as status quo is concerned, the eventual enactment of continuance – importing and exporting companies – is also a factor to be considered. The shareholders of a company governed by the Act could be more inclined to continue the company under legislation that grants them more rights and protection, and on the contrary, shareholders of a federal company or one governed under the legislation of another province could be less inclined to continue it under the Québec Act which grants them fewer rights and less protection.

3.1.2 Increase in the rights, powers and protection of shareholders

Several jurisdictions have chosen to increase the rights and recourses of shareholders to prevent their interests from being completely neglected by company administration. Such provisions for the benefit of shareholders would in themselves have a tendency to improve good governance within companies. For such purposes, several measures could be studied during the work undertaken for the reform. Here are some examples:

❑ Review protection for minority shareholders in connection with multiple voting shares

Although criticized by some actors, multiple voting shares are most often considered as being advantageous for the economic development of Québec. In fact, several large Québec corporations which have developed remarkably, such as Bombardier Inc. and Alimentation Couche-Tard Inc., have adopted a capital structure with multiple voting shares.

Investors who purchase shares in this type of company literally purchase the values of the majority shareholder. In fact, this structure is used among other things to ensure the continuity and commitment of the founding entrepreneur in the company. Such a structure also allows the company to defend itself against hostile takeover bids.

On the other hand, the fact that some companies chose for various reasons to issue multiple voting shares may entail unfavourable conditions for minority shareholders. Would it be necessary for Québec to adopt measures to control such a practice? Which ones would be appropriate?

❑ Facilitate filing shareholders' proposals

Under the CBCA and some provincial legislation, shareholders may make proposals to amend the articles of incorporation or regulations during an annual meeting, thereby giving shareholders the initiative for these changes.

In Québec, the provisions concerning shareholders' proposals (sections 98.1 to 98.12), which are similar to those of the CBCA are not in force, as the government must first enact the regulations.

In any event, the eventual application of these provisions is a problem because they conflict with the provisions of the Act which require the enactment of a regulation beforehand by the board of directors and the convening of an extraordinary meeting (for changes to articles of incorporation), which could make them unenforceable. Therefore, an adaptation would be required if it were decided to have them come into force.

❑ Right of dissent

Elsewhere in Canada, dissenting shareholders who disagree with certain important changes to the structure or activities of a company, have the right of dissent, that is to say, the right to have the company redeem their shares at their fair market value.

Should shareholders of Québec companies have such a right?

❑ Introduction of recourses for minority shareholders, such as a formal recourse for oppression

This is an equitable remedy for which a court has almost unlimited remedial powers in case of an abuse of right or injustice on behalf of the company or its directors and which infringes on the interests of shareholders, directors, officers and creditors.

As far as companies governed under the Act are concerned, minority shareholders do not have any such recourse. In spite of the fact that over the years, Québec courts have had a tendency to compensate for the lack of a recourse for oppression by broadening the traditional limits of the superintending and reforming power under article 33 of the Code of Civil Procedure to legal persons, no one can really say what the limits of such an initiative may be, thereby creating serious uncertainty for all companies.

The uncertainty as to the exact scope of the superintending and reforming power of the Superior Court has led numerous corporate lawyers to wish that the Act specifically provide for a "recourse for oppression" similar to the recourse under the CBCA, which after more than 30 years of use, is well known and interpreted by case law.

❑ Advantages and inconvenience

In case the increase of the rights, powers and protection of shareholders is considered, the advantages for them would be obviously immediate. The situation would be quite the contrary for company directors, who would have to perform their duties in a more transparent fashion and eventually face more intervention on behalf of shareholders. This also implies that they would be liable to a greater number of sanctions in case of the infringement of the rights of shareholders, and as a corollary to that, there would be a potential increase in the liability insurance premiums in connection with their functions.

3.1.3 Increase in the protection of directors

The third possibility is establishing a legal framework in Québec based on the "management friendly" legislation in Delaware, which is the most sought after state for incorporating large American corporations. Such a choice could be warranted by the intent to place Québec in a market niche which seems to be especially popular in corporate law by immediately adopting the American approach of "Business Judgment Rule", the influence of which is irresistibly felt in Canadian corporate law and which was aknowledged by the Supreme Court of Canada in *Peoples Department Store v. Wise* in 2004.

Therefore, certain additional measures of protection for directors would be added to the *status quo* scenario, including the four which follow:

— Codify the "Business Judgment Rule", for example on the basis of subsection 180(2) of the Australian *Corporations Act 2001*;

> In general, the principle of the "Business Judgment Rule" may be invoked by directors who acted in good faith on the basis of sufficient information at the time when business decisions were made, which are now criticized and which do not involve any infringement of their duties as trustee. Courts will not intervene retroactively in such situations.

— Allow inserting an exoneration clause in the articles of incorporation ("Raincoat Provision")(4) to cover directors for their shortcomings in their duties of prudence and diligence, which would prevent shareholders and creditors from suing them in damages. In the current state of law, this type of clause is specifically prohibited in other Canadian provinces and in the federal act, as well as implicitly in Québec;

— To withdraw financial tests from the act, which are a source of liability for directors;

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(4) Clause based on paragraph 102(b)7 of the *Delaware General Corporations Law*, or on subparagraph 2.02(b)(4) of the *Model Business Corporations Act*.

— Restrict the removal of directors with staggered terms of office[5] ("Classified Boards"), which would prevent a purchaser of shares from appointing a majority of directors or more and would constitute a very efficient means of defence to counter hostile public takeover bids.

❑ Advantages and inconvenience

Such measures would be certainly unpopular with investor protection groups, but they would make Québec a "Delaware of the North", that is to say, a major attraction not only for large Canadian corporations but also for American corporations. To benefit fully from the competitive advantage that these measures would ensure for jurisdiction shopping, they could be combined with continuation – importing and exporting.

However, it is far from obvious that this choice will suit small enterprises, which are the main clientele under the Act. Current law grants relative remedial recourses to minority shareholders. The enactment of provisions ensuring greater protection to directors is likely to render their situation even more precarious. This could even restrict any investment by these shareholders which is essential for these small companies.

3.2 Improvement in governance rules

3.2.1 What is involved in governance

Scandals, stock market excesses and the financial crises of the last years have shown the importance of good corporate governance. This governance, which tends to reassure investors that their savings are in good hands and that management performs its duties striving to increase the value of their savings through the long-term prosperity of the company, must however be delimited using standards acknowledged by all parties interested in corporate existence.

Therefore, a study of the inclusion of governance rules in the Act must be undertaken in Québec. Besides, the possibility of requiring or maintaining a voluntary respect of the rules of good governance and to extend the duty of disclosure in the Act must be assessed. On this point, one of the solutions may possibly be the efficient combination of legislative provisions and of principles issued by the *Autorité des marches financiers* (AMF) [the Quebec financial markets regulator] for the issuers of securities subject to the *Securities Act*.

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(5) It is possible in Québec to establish staggered terms of office. However, this possibility is more detailed in the Delaware legislation (subsections 141 (d) and (k)). It provides that directors can be elected to the board of directors according to various classes for terms of office of one, two or three years, which expire alternatively and which cannot be terminated except for just cause. Therefore, in Delaware, directors with staggered terms of office are better protected. However, shareholders may decide otherwise right from the start in the articles of incorporation or vote to amend the regulation providing for staggered terms of office.

However, it must be considered that analysts do not agree with the appropriateness of rules concerning good governance. If some authors advocate their enactment, others are of the opinion that they hinder the normal development and performance of corporations by forcing them to be overly cautious, which would impede their actions and overly minimize the risks which are however inherent in the world of business.

If such provisions were to be added to the Act, should they concern any type of company? If not, what criterion should be used to confine companies? In Québec, currently only public companies under the regulations of the AMF, have the obligation of disclosing the rules of good governance they chose to adopt. This is a free and voluntary desire to abide by the principles of good governance established by the Canadian Securities Administrators (CSA). Is the criterion of public corporation as compared to a private corporation sufficient?

3.2.2 Overview of some reforms centered on governance

Corporate governance involves stakes which are important on a global scale due to recent scandals (Enron, Parmalat, etc.) which involved corporate officers.

Over the last few years the debate on governance has considerably amplified. According to the Organization for Economic Co-operation and Development (OECD), some 30 codes of governance have been adopted over the last decade in the member countries of the European Union (EU) to better protect shareholders' interests.

Most reform of company legislation which targeted governance was undertaken to ensure greater transparency and better access to information for company shareholders. Such reforms have led to much stricter internal control and management mechanisms.

The Commission of the European Communities has noted that company governance codes within the EU are remarkably similar(6).

In most cases, the adoption of codes of governance by companies is done on a voluntary basis. These rules are specified in codes which companies decide to adopt, and sometimes even in legislation. When companies do not adopt such codes, they have to explain the reasons for that. Disclosure of the adoption or not, of these rules is an obligation in most countries. This obligation is not necessarily contained in any company legislation.

However, Germany, Spain and the United Kingdom have codified in their legislation the principle of "adopt or explain."

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(6) COMMISSION OF EUROPEAN COMMUNITIES, *Modernisation du droit des compagnies et renforcement du gouvernement d'entreprise dans l'Union européenne. Un plan pour avancer*, Bruxelles, [Modernization of Company Law and Reinforcing Company Governance. A plan to Move Ahead] 2003, 284 pages.

Recently, Swiss law has also adopted new provisions to encourage good governance. These provisions which are in force since January 2007, contain more severe rules for disclosure for company officers, especially concerning financial information and methods of remuneration.

In Canada, since the 2001 reform, the CBCA contains some provisions concerning good governance (especially those concerning the audit committee). Since this reform, the CBCA has placed an accent on shareholder protection. The federal government is on the verge of adopting other measures concerning good governance based on the principles advanced by the CSA, as was mentioned in section 2.1.

The federal government has jurisdiction to enact company legislation. It has jurisdiction to incorporate companies which have objects that are other than provincial, according to the theory of residual power. At the federal level, the choice of legislation was obvious. Rules of governance are found in the CBCA, as they could not be inserted in any securities legislation, which is of exclusive provincial jurisdiction.

Things could be different as far as the provinces are concerned.

3.2.3 Linkage with securities legislation

In Québec, only public companies have the obligation to disclose the rules of good governance they chose to adopt. They are free to adopt the principles of good governance advocated by the AMF under the *Securities Act*.

Accordingly, additional rules of governance could be logically inserted in the *Securities Act* in addition to those specified in the *Companies Act*. Such a situation could specifically target companies which make public offerings and whose size warrants recourse to such more stringent rules.

However, the insertion of such rules in the Act could make them into duties or obligations subject to judicial recourses rather than to merely administrative sanctions. If these rules are too stringent, they may be a disadvantage for the Act and encourage jurisdiction shopping. However, this question may not even arise if the rules of governance are harmonized with those adopted elsewhere in Canada.

On the other hand, must companies which are not subject to the *Securities Act* be removed from the application of any governance rule? If not, what would be the minimum rules to be included in the Act?

3.3 Increase in competitiveness and attractiveness

The government considers that the revised Act should allow maintaining companies presently incorporated in Québec, incite existing businesses to incorporate and be attractive to foreign businesses seeking a legislative structure. The following solutions are suggested to attain these objectives.

3.3.1 Financial assistance for shareholders

A company incorporated under Part IA cannot make loans to its shareholders unless it meets complex requirements of solvency and available cash.

Financial assistance

Directors may, in the company's interest, sometimes make loans, grant sureties or other types of financial assistance to shareholders, to those of the holding company or to another person, except if the company cannot meet its liabilities when due (solvency test) or if the book value or the value of the realization on its assets (after deducting the amount of the financial assistance) is less than the sum of its liabilities and its paid-up share capital account (available cash test). Directors may become solidarily liable for the unrecovered amounts if the requirements in connection with the tests are not respected.

In fact, under the Act, any transaction by which amounts of money or company assets are remitted to its shareholders, is subject to a financial test.

These transactions are grouped in the chapter entitled "Rule respecting the maintaining of the capital" and includes acquisition (purchase or redemption) of shares, reduction of the share capital, financial assistance and payment of dividends.

The application of these tests is a problem because:

— The notion of "value of the realization" is not defined and is difficult to use because it is so imprecise. Chartered accountants are instructed not to give any opinion about it(7).

— The assets of a company may be determined by using the book value or the realization value. Either one of these methods is the basis of the financial tests which directors must apply before being able to conduct a transaction involving the share capital of the company.

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(7) CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS, « *Service relatifs à des questions de solvabilité* », Note d'orientation concernant la vérification et les domaines connexes, Manuel de l'ICCA, [Services concerning matters of solvency - Notice concerning auditing and related fields - CICA Handbook] Nov. 4, 1988.

"Interpretation of the expression "realization value" creates some uncertainty. On one hand it is said that this expression designates market value, and if there is no market, a reasonable selling price. On the other hand, it has also been said that realization value is often less than market value because forced liquidation usually generates less than the sale of a going concern. Therefore, the expression "realizable value of assets" has a very broad meaning and may designate a number of things[8].[OUR TRANSLATION]

— The accounting notion of "liability" has evolved since the enactment of Part IA of the Act to include amounts which were not initially included as a "liability" such as the purchase price of shares redeemable at the request of their holders or at a predetermined date, which makes these tests too restrictive and sometimes involves a double accounting for certain amounts, especially for the redemption of shares.

On the other hand, the potential liability of directors for a loan from a holding company is an obstacle to financing groups of companies and puts Québec at a disadvantage in jurisdiction shopping, considering that the CBCA and the legislation in other provinces have done away with this obstacle.

However, these difficulties may be eliminated.

One solution would simply consist in repealing the tests concerning financial assistance, such as was done with the CBCA with the 2001 reform and in the Ontario legislation in 2007.

The drawback of this solution is its lack of consistency by ceasing to restrain a type of derogation to the maintenance of capital rule (financial assistance) while continuing to restrain other types (payment of dividends, purchase of shares and reduction of capital).

The other solution would involve the repeal of the available cash test while maintaining the solvency test which could even concern not only financial assistance but other types of infringements of the rules respecting the maintaining of capital (payment of dividends, purchasing shares and reduction of the share capital). Statutory protection of creditors and shareholders would continue to be assured by the application of the general duties of directors and in case of the infringement of these duties or of some injustice to shareholders, by judicial intervention.

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(8) JAMES SMITH, *La Partie IA de la Loi sur les compagnies – Les commentaires*, vol.3, [Part IA of the Companies Act – Comments, vol. 3] Montréal, C.E.J., 1981, p.217.

This solution seems to have its advantages because of its simplicity and clarity. It has been adopted in the new British Columbia *Business Corporations Act*. It respects the concept of maintenance of capital which was initially designed to protect creditors by ensuring that they will maintain their priority as compared to shareholders, on the assets of the company.

3.3.2 Defence of due diligence for directors

Since 2001, the CBCA provides for a defence of due diligence for directors which is broader than the defence under the Act, which is restricted to a defence based on the fact that a decision was rendered on the basis of an expert's opinion or report. Such a defence cannot be invoked in connection with liability for employees' wages.

One solution which may be attractive to company founders who intend on becoming directors would consist in granting to directors a defence of due diligence at least as broad as the one under the CBCA, which may be set up against all cases of civil liability, including employees' unpaid wages.

3.3.3 Introduction of unlimited liability corporations

Unlimited liability corporations[9] are an additional type of corporation which can currently be incorporated in Nova Scotia, Alberta and British Columbia. Although unlimited, the liability of shareholders of such a corporation is not automatic. This liability will only be sought at the winding up of the company if its assets are insufficient (in the case of the unlimited liability corporation in Nova Scotia).

Because of the criteria mentioned by the Supreme Court of the United States in a judgment dating back to 1935[10], ULCs may be considered by US tax authorities as partnerships. In addition, US tax authorities reaffirmed the criteria of the Supreme Court in regulations which were adopted and they confirmed in 1995 that Nova Scotia ULCs were considered as partnerships for American tax purposes [11].

For example, status as a partnership allows an American shareholder of a ULC to directly deduct from his own personal income the interest paid on any loan due by the Canadian ULC, as in the case of a partner in a real partnership.

In addition, in Canada, ULCs are real legal persons and may also deduct interest in their own tax returns. This is therefore a double deduction for the same amount of interest and this makes this type of corporation attractive to American entrepreneurs.

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(9) *Unlimited Liability Companies* (U.L.C.).

(10) Morrissey v. Commissioner, 296 U.S. 344 (1935).

(11) INTERNAL REVENUE SERVICE, LTR 9538020, June 22, 1995; Tax Analyst, 95 TNI 186-8, September 22, 1995.

Therefore, the use of a ULC for Canada-United States transboundry transactions is based on the major tax advantage it has, due among other things, to the possibility of obtaining two deductions for one investment disbursement (cumulating deductions). However, the existence of these tax advantages is challenged under the *Protocol Amending the Convention Between Canada and the United States With Respect to Taxes on Income and on Capital*, signed on September 21, 2007.

The taxation rules applicable to this type of corporation are presently being analyzed by the ministère des Finances. In addition, the Department of Finance Canada has some preoccupations about the use of ULCs concerning the tax rules applicable to foreign operations of Canadian corporations.

3.3.4 Continuation

Continuation is a mechanism that allows companies incorporated under specific legislation to **continue their existence under another companies act**.

In Canada, the Act is the only piece of legislation that does not allow the continuation of a Québec company under another act (exporting) or the continuation of a company under the Act (importing).

The lack of such a mechanism was warranted at that time by the fear of an exodus of Québec companies to other Canadian jurisdictions. In any event, it is possible to circumvent this lack. In fact, Québec companies which may want to be continued under another jurisdiction may indirectly attain this result by using the relatively complex mechanism of three party amalgamation.

To the extent that the reform aims to make the Act just as attractive, if not more, than corporate legislation in other jurisdictions, nothing should prevent the continuance mechanism from being inserted therein. Without this mechanism, the Act is likely to remain less attractive to company directors. On the contrary, the possibility of continuance could attract companies whose shareholders had initially opted for the CBCA and who would now like to have the comparative advantages of the reformed Act.

3.4 Modernizing and streamlining company law

3.4.1 Reform of the structure of the Act

The present structure of the Act is obsolete and not very user-friendly. Part I of the Act concerns companies incorporated by filing letters patent. However, in Québec, companies are no longer incorporated this way since Part IA was added to the Act. However, this part of the Act was maintained during the last review. Today, some provisions still govern companies incorporated by the filing of articles (Part IA) by making the "necessary adaptations."

When conducting the reform of the *Canada Corporations Act*[12] in 1975, the federal government had compelled corporations incorporated with letters patent to continue their existence with articles of incorporation within a compulsory time limit of five years, following which they would cease to exist.

Accordingly, since 1980, the CBCA is an integrated and complete legislative structure for Canadian share capital corporations.

For the purpose of simplifying Québec law, the possibility of repealing Parts I and IA of the Act and replacing them with one integrated act governing all Québec companies and to require continuation of existing companies which were incorporated under the repealed Parts I and IA, under this new act, could be considered.

3.4.2 The Act and SMEs

Noting that the Québec Companies Act governs mostly SMEs, it is important to pay specific attention to the legislative rules which apply to them. Are these rules too complex? Does the Act apply rules which are too complicated or expensive or which hinder incorporation or the economic development of companies?

Based on its income, the number of employees and shareholders, a private company, just like an SME, generally has different needs than those of a public company, especially concerning the holding of meetings and the protection of minority shareholders.

It could be appropriate to study the possibility of enacting specific legislation for SMEs, to insert a specific chapter in the Act or to insert in the Civil Code of Québec, provisions which are relevant to SMEs. A continuation of the company could be possible under either one of the acts as the company develops.

The rules applicable to SMEs and even possibly to all private companies could feature among other things:

— A loosening of the rules of operation in the case of a "one person company;"

— Simplifying decision-making procedures, especially when directors are the only shareholders in the company.

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(12) Later to become the *Canada Business Corporations Act*, R.S.C. (1985), c. C-44.

❑ Situation in Delaware

The "close corporations" in Delaware are a type of business which would be defined in Québec law as a closed legal person and as an incorporated partnership[13]. "Close corporations" have a distinct legal personality when dealing with their members. In fact, the *Delaware Companies Act*[14] provides that the certificate of incorporation of the "close corporation" may specify that it will operate as a partnership without it losing its status as a corporation. The Delaware Act includes a specific chapter for "close corporations."

The share capital (voting shares) of this type of company is often not widely held (a maximum of 30 voting shareholders) and is not easily negotiable. However, the size of the corporation may be impressive and the fact that it is a "close corporation" does not mean that the business is a small-scale.

Shareholders in this type of corporation are most often close relatives or friends. In fact, American legal writing mentions the close relationships which are featured in this type of corporation. "Close corporations" often involve a continuous commitment by shareholders who are often directors, officers and employees of the company.

❑ Situation in the United Kingdom

The reform of company law undertaken in the United Kingdom has several objectives, including that of encouraging private companies by simplifying the regulations which apply to them. In fact, the British Minister of Industry coined the slogan of "Think small first" to describe the reform. This is testimony to how important the government considers adapting company legislation to the specific situation of SMEs may be.

Right from the beginning of the reform of British law, the committee in charge of the reform had underlined the fact that the law imposed too many rules on small companies. According to this committee, because this legislation was not sufficiently transparent, it entailed omissions in properly abiding by it.

In fact, the law was complex and confusing. For example, company directors were too often unable to clearly understand the basic procedures to be followed, as well as their duties and rights in the administration of their company.

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(13) STEPHEN BAINBRIDGE, *Corporation Law and Economics*, Foundation Press, 2002, 884 p.

(14) Delaware Code Title 8: "Corporations."

The proposals made during the reform concerned:

— The introduction of measures to simplify the administration of companies, such as the decision-making process[15] or the incorporation of a company;

— Protection of the rights of minority shareholders to encourage risk capital while restricting the number of inappropriate interventions they can make so as to not hinder the economic activities of the company;

— Clearly specifying the provisions of the act which apply in a compulsory manner to private companies.

The British government finally adopted most of the recommendations concerning SMEs made by the reform committee by inserting in the *"Companies Act of 2006"* provisions which were adapted to the needs of SMEs. The new Companies Act received Royal assent on November 8, 2006 and came into force in January 2007.

United Kingdom - Examples of measures introduced for SMEs

- Simplification of incorporation procedures and reduction of the amount of information to be supplied to the Registrar.
- The holding of an annual meeting is no longer required unless demanded by 75% of the shareholders (to be specified by an amendment to the company regulations, which requires a special resolution).
- All ordinary written resolutions, signed by 50% of the shareholders entitled to vote, are valid. This percentage is increased to 75% in the case of special resolutions. They are considered to be validly approved at a general meeting.
- Codification in the *Companies Act of 2006*, of the duties of directors, which were previously based on various sources, including the common law.
- Possibility for a company to make loans to its shareholders.
- If specified in the incorporation documents, a transaction giving rise to a conflict of interest between the company and one or more directors may from now on be directly approved by the other directors without being subject to approval by the shareholders.

(15) Among other things, the committee recommended that the act clearly specify that any decision the company has the authority to make, be made without having to abide by any of the provisions concerning this subject in the act when the shareholders unanimously decide so. This is the codification of a principle of common law to the effect that an informal legal agreement which is unanimously approved is just as valid as a resolution adopted at a general meeting.

3.4.3 Adapting the Act to new technologies

In its report published in March 2002, the "King Committee on Corporate Governance" of the Republic of South Africa, whose work concerned the principles of governance applicable to corporations, recommended inter alia, that voting at shareholder meetings and the transmission of proxies be done electronically so as to facilitate as much as possible communications between shareholders and companies.

On the other hand, the authors of the report underlined the fact that companies should be authorized to submit their corporate documents electronically as long as a paper version is available on demand by any interested party.

> *"Given the move towards a greater application of information technology to speed up communication and transmission of information, the Companies Act should be reviewed to identify areas where electronic communication would improve governance and communication between companies and their shareowners. A particular area for consideration, in line with developing international practice, is electronic voting by shareowners and the electronic transmission of proxies"*(16).

Several technical means already allow for electronic voting, as well as for electronic communications. In fact, many corporations use electronic means. However, the provisions of the Act have not been adapted to authorize this. It must be determined if the Act could be amended on the basis of the provisions of the *Act to establish a Legal framework for information technology* so as to facilitate the use of these various means.

❑ Electronic communication between companies and shareholders

In Canada, under the CBCA, any company may from now on forward its corporate documents electronically or using other technological means, as long as a paper version exists and is available on demand to interested parties. The drafting of the new provisions is flexible so as not to require corporations to use special technology.

On the other hand, under the CBCA, books and registers may be kept abroad if they are available in Canada by electronic means. The present drafting of the Québec Act creates a doubt about the possibility of maintaining books and registers electronically and abroad.

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(16) KING COMMITEE ON CORPORATE GOVERNANCE, King Report on Corporate Governance for South Africa, Institute or Directors in Southern Africa, 2002.

❑ Meetings and electronic voting

In France, the [Act of May 2001 concerning new economic regulations] *Loi de mai 2001 sur les Nouvelles régulations économiques*, allows attendance by shareholders at annual meetings using electronic means, by amending the rules governing quorum and majorities. Shareholders and directors may from now on perform their functions without being physically present.

The CBCA also allows shareholders to attend meetings of shareholders and to vote by any means of communication (telephone, electronic means or others; subsection 132 (4)(5) of the CBCA) provided that the corporation's articles authorize this first of all.

❑ Filing documents by Internet

At the federal level, the Corporations Canada Online Filing Centre allows registered users to file by Internet all notices and documents (articles of incorporation, annual reports, changes of address, changes in directors and other forms) required under the CBCA.

Online filing has advantages, such as:

— Considerable practicality: filing can be done directly from the office or home and the electronic filing centre is open 24 hours per day;

— Rapid processing of articles of incorporation: because applications are directly sent to a data base, Corporations Canada may process them on the same day or the following day, depending on the time of the filing and the complexity of the application.

Moreover, the Corporations Canada Online Filing Centre features a reduction in incorporation fees. Transactions made through the Online Filing Centre are charged $200 instead of the usual $250 fee.

In Ontario, the Website www.OnCorpDirect.com has the same functions. This is one of the businesses whose services were retained by the Department of Government Services to allow corporations to electronically file their articles of incorporation, annual reports, change of address, change of directors and other forms. The Cyberbahn Inc. and Dye & Durham are other private suppliers. The Department charges a $300 fee for the electronic filing of articles of incorporation. Service suppliers charge additional fees for their online services.

In order to adapt the Québec Act to the age of new technologies, such a service should be available to Québec companies. It would also meet the government's desire to simplify the administration of enterprises as stated in its *Plan d'action gouvernemental en matière d'allégement réglementaire et administratif en faveur des entreprises* filed in August 2004. [Government action plan to streamline regulations and administration for enterprises].

Conclusion

A whole series of possibilities may be studied during the reform of Québec company law. This is why the suggestions made in this working paper are not in any way exhaustive. These suggestions are only the starting point for a wide sweeping endeavour.

Most countries periodically review their legislation so that it may have a positive influence on their economy.

Therefore, acknowledging that the *Companies Act* is important legislation which has a significant impact on the economy and the fact that the reform of company law in Québec has become a necessity, the government of Québec has decided in publishing this working paper, to initiate the work which will lead to this reform.

Any person or organization interested in voicing an opinion for the purposes of this endeavour must submit comments by March 14, 2008 at the latest. The filing of such comments by email would be most appreciated. The comments received could be rendered public for the purposes of the review.

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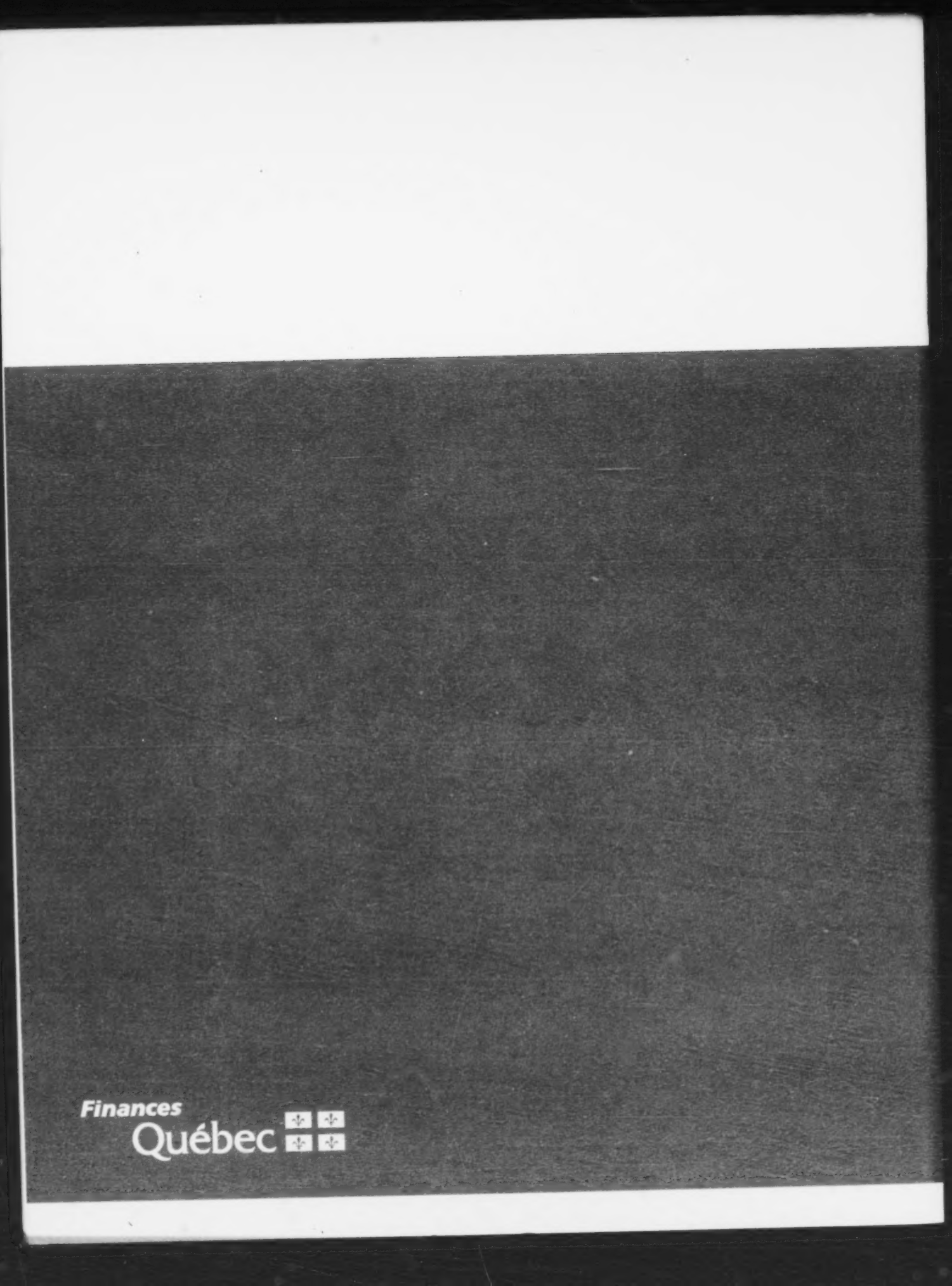
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